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No. 03-1495

IN THE

Supreme Court of the United States

SUSAN MORAN, *et al.*,
Petitioners,

v.

J. ELLIOTT HIBBS, *et al.*,
Respondents.

On Petition for Writ of Certiorari to the Supreme Court of Arizona

REPLY IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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In its opposition, Arizona makes no effort to minimize the importance or pervasiveness of the federal question presented here. Nor does it deny the fact of the unequal treatment of federal employees or contest our assertion that the challenged discriminatory taxation directly implicates the interests of the United States. Rather, Arizona argues principally that the decision below is correct on the merits.

Whether the decision below is right on the merits is ultimately a decision for this Court to make; suffice it to say the unanimous decisions of Arizona's lower courts, finding the discriminatory taxation unconstitutional, demonstrate that the conclusion below is anything but ineluctable. Moreover, Arizona offers no reason to believe that the United States would agree with the decision below, a decision validating a discriminatory tax scheme that forces the United States to subsidize the employment costs of the State of Arizona, as

well as 28 other states. Review by this Court is necessary to address the constitutionality of this pervasive tax scheme and nothing Arizona offers in its opposition suggests otherwise.

1. Central to its argument on the merits—indeed the crux of how Arizona frames the issue before the Court—is the fact that the Congress has excluded from *federal* adjusted gross income the amount of mandatory employee retirement contributions "pick[ed] up" by state employers. *See* Op. Cert. at i. Arizona contends that because Congress has authorized it to pay the mandatory employee contributions for its employees and because Congress has excluded these payments from federal adjusted gross income, its discriminatory taxation of the identical component of federal employees' compensation passes constitutional muster.

Arizona's reliance on the Internal Revenue Code to sanction its discriminatory taxation is misplaced. As this Court made clear in the context of the Commerce Clause, "[t]he adoption of the federal system in whole or in part, [. . .] cannot shield a state tax statute from Commerce Clause scrutiny." *Kraft General Foods, Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71, 82 (1992). Arizona offers no reason to suspect that this admonition applies to the Commerce Clause, but not to the Supremacy Clause, and indeed there is none.

Arizona contends that it is merely following federal law. But federal law does not *require* Arizona to exempt mandatory employee contributions from state income tax. Arizona, in the exercise of its sovereign power, has *chosen* to grant this exemption to state and government employees only. Many states that similarly have adopted the federal definition of adjusted gross income have nonetheless chosen to equalize the treatment by imposing state income tax on these contributions even though they are excluded from federal gross income. *See e.g*, Kan. Stat. Ann. § 79-32, 117(b)(vi) (2003); Me. Rev. Stat. Ann. tit. 36, § 5122(G) (West 2003); Md. Code Ann., Tax-Gen § 10-204(f)(1)-(2) (2003); Mass. Gen.

Laws Ann. ch. 32, § 22(10), ch. 62, § 2(a)(1)(1) (2004); N.Y. Tax Law § 612(b)(26) (Consol. 2004).

The Internal Revenue Code simply provides no cover for Arizona's discriminatory taxation. The favored treatment is the direct result of discriminatory legislative action by the State of Arizona. *See Pennsylvania v. Curtis Pub. Co.*, 69 A.2d 410, 422 (Pa. 1949) ("The legal effect of this State's basing its computation of tax on the net income returned to and ascertained by, the federal government is exactly the same as if the Commonwealth had prescribed the same tax base without any reference whatsoever to the 'federal returns'."). Indeed, it is now generally understood that,

> [i]n conforming their tax schemes to the federal model, states incorporate federal tax rules that may not . . . recognize the constitutional restraints on state taxing power. . . . Mechanical application of federal rules . . . at the state level produces results that [may be] . . . unconstitutional.

James C. Smith & Walter Hellerstein, *State Taxation of Federally Deferred Income*: *The Interstate Dimension*, 44 Tax L. Rev. 349, 399 (1989).

Of course, the decision below also directly conflicts with two published decisions of two different panels of the Arizona Court of Appeals. *Pet. App.* 23a-49a; 108a-144a. Significantly, each of these decisions was based upon the extensive, uncontroverted record for summary judgment established by the petitioners. The records in each case established that the element of compensation representing contributions of the two groups were substantively identical. The records also established that Arizona's scheme discriminated in favor of State and local employees and that there was no provision of Arizona law for any of the years in issue by which federal employees could qualify for equal treatment. In fact, the practical effect of Arizona's scheme is to exempt state and local employees only. *Pet.*

App. 132a. This is confirmed separately in the substantive provisions of Arizona pension statutes, which independently grant this exemption. *Pet. App.* 157a-163a.

Thus, the record below establishes that there is overt discrimination based solely on the source of pay. The favored treatment was expressly limited to state and local employees and there was no Arizona provision for any of the years in issue by which equal treatment would be extended to federal employees. This problem is not, as the court below held, one for Congress to mend. Rather, it is one of Arizona's making. Because Arizona has refused to remedy this discrimination, this Court must.

2. Arizona also argues that the decision below does not conflict with the decisions of any other state. In so doing, however, Arizona has unwittingly identified yet another parallel between this case and *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989). When this Court granted certiorari in *Davis*, no other court had held that discriminatory taxation of federal pensions was unconstitutional. Indeed, the lack of prior authority invalidating the tax was the cornerstone of the states' (including Arizona's) failed effort to have *Davis* applied prospectively only. *See Harper v. Virginia Dep't of Taxation* 509 U.S. 89, 93 (1993). The lack of countervailing state court authority was not an impediment to review in *Davis* and likewise it is not an impediment here.

In any event, Arizona is myopic in asserting that there is no opposing state authority. As noted above, several states have cured the discrimination by imposing state income tax on their employees' mandatory contributions to state and local pension plans. Maryland, for example, imposes this tax on state employees. So too, its Court of Appeals has recognized the infirmity of relying on the Internal Revenue Code as a shield for unconstitutional state taxation. Specifically, in *Comptroller of the Treasury, Income Tax Div. v. First United Bank & Trust*, 578 A.2d 192 (Md. 1990), the State argued

that the Maryland tax imposed on a mutual fund's distribution of federal interest was constitutional because it was the direct result of a distinction in the federal income tax. The Court of Appeals rejected as "unsound" the Maryland Attorney General's opinion that the Maryland tax on federal interest was valid because the "discrepancy is the direct result of distinctions drawn by federal law . . . ." *Id.* at 199.

Moreover, the reasoning of the Arizona Supreme Court directly conflicts with a long line of authority. As noted above, over fifty years ago the Supreme Court of Pennsylvania squarely rejected the states' tactic of seeking to hide behind the Internal Revenue Code. In *Pennsylvania v. Curtis Publishing Co.*, 69 A.2d at 414, Pennsylvania defended its discriminatory tax by claiming that its corporate tax was based solely on the federal returns of corporations doing business in Pennsylvania. The Pennsylvania Supreme Court rejected the State's justification because it ignored the fact that the tax in issue emanated from the sovereignty of Pennsylvania. *Id.* ("By adopting this mode of ascertaining the tax to be imposed, Pennsylvania did not delegate to the Federal government any of the State's power to tax. The act of taxing is the act of the Commonwealth.") Thus, Pennsylvania too recognizes that using federal income as a starting point cannot justify the imposition of discriminatory state taxes. Similar results have been reached in a number of states. *See Brown v. Franchise Tax Bd.*, 242 Cal. Rptr. 810 (Cal. Ct. App. 1987); *Andras v. Illinois Dep't. of Revenue*, 506 N.E.2d 439 (Ill. App. Ct. 1987); *Matz v. Dep't of Treasury*, 401 N.W.2d 62 (Mich. Ct. App. 1986); *Borg v. Dep't of Revenue*, 774 P.2d 1099 (Or. 1989); *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); *Capital Preservation Fund, Inc. v. Dep't of Revenue*, 429 N.W.2d 551 (Wis. Ct. App. 1988).

Accordingly, Arizona's contention that there is no conflicting state court authority is misguided. The question presented here, involving discriminatory taxation of manda-

tory employee retirement contributions, is one of first impression that has never been raised in any state courts other than Arizona's. But the basic tenet of the decision below–that a state may blithely rely upon the Internal Revenue Code without regard for potentially unconstitutional consequences–is one that has been rejected by this Court and several state courts. Thus Arizona is wrong in asserting that there is no contrary state court authority; indeed, the conflict between the decision below and the decisions of this Court and numerous state courts is a compelling reason for this Court to grant certiorari.

3. In our petition, we argued that this case is substantively identical to *Davis v. Michigan* with two exceptions: 1) that this case involves the *current* compensation of federal employees, not deferred compensation; and 2) that Arizona's discriminatory tax scheme is even more prevalent (utilized in 29 states) than was the discriminatory pension tax invalidated in Davis. Thus, this case involves "discriminat[ion] against [the United States] or those with whom [it] deals"[1] to an even greater extent than did *Davis* and, as such, even more significantly implicates the interests of the United States. For this reason, petitioners submit that this Court should grant certiorari to ensure that states may not discriminate against the United States, and its employees, in the taxation of mandatory retirement contributions.

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[1] *Memphis Bank & Trust Co v. Garner*, 459 U.S. 392, 397 (1983).

CONCLUSION

For the foregoing reasons, and for those reasons previously set forth in the petition for a writ of certiorari, this Court should grant certiorari to review the decision of the Supreme Court of Arizona.

Respectfully submitted,

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